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Repurchase Obligation Studies & The Other Importance of Future Share Price Estimates

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Overview

Planning for ESOP repurchase obligation is an important issue facing companies with an employee stock ownership plan ("ESOP") when their stock is not traded on a public exchange. This liability is the result of the company's obligation to pay participants for their allocated and vested shares when they separate from the company or when ESOP participants choose to exercise diversification rights under the terms of the ESOP. Repurchase obligation **often** represents a significant cash demand that can impact operating decisions as well as per share value. This article will review a number of common issues that lead to inaccurate estimates of future share price and the resulting impact on repurchase obligation studies.

The majority of articles and focus regarding the topic of business valuation relate to current or plan year end valuations; however, when an ESOP is present, it is also important for ESOP Trustees and management to have a sound understanding of a company's future share price expectations. Key data points for this type of analysis are similar to those utilized in the annual valuation, including expectations of market generated cost of capital, multiples of earnings and cash flow as well as internal cash generators/demands such as profit, capital expenditures, working capital needs, debt requirements, deferred compensation, synthetic equity plans, potential S-corporation benefits, repurchase obligation, ESOP distribution policies and other company specific factors.

Value & Repurchase Obligation Studies

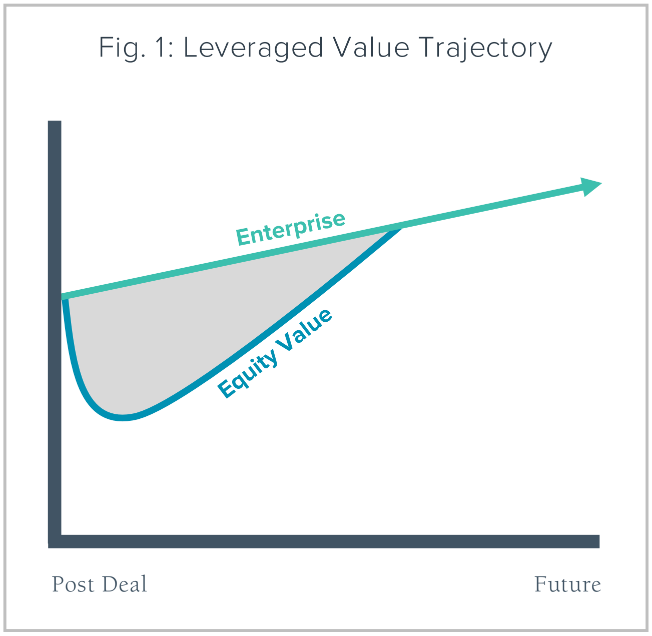
It is a best practice for ESOP-owned companies to engage in a detailed review of the future impact of the ESOP repurchase obligation. Most often, these studies are conducted by professionals within the ESOP community through the use of repurchase obligation software or via basic excel models. Repurchase obligation studies are conducted to estimate the company's future cash demands by forecasting anticipated participant turnover and diversification requirements while incorporating the sponsoring company's policy decisions and ESOP requirements as to how these shares will be purchased and over what period of time. These simulations utilize a large amount of actuarial data to estimate the number of shares that will be required to be repurchased over time. This share count is then converted to dollars using estimates of future per share price. These studies result in a forecast of the cash flow demands required to satisfy the repurchase obligation in any given year.

While a quality estimate of the required number of future share purchases can be developed through a thorough analysis of actuarial data, too often the estimates of share price appreciation are loosely developed and do not incorporate the methodologies utilized by the ESOP appraiser or the valuation impact of the policy decisions established by the company. Inappropriate estimates of share price appreciation can significantly affect the quality of the repurchase obligation study. In turn, this can lead to poor operating decisions and may impact annual ESOP valuations, as ESOP appraisers utilize this output when conducting the annual valuation.

Projecting Future Share Price

While there are many factors that can lead to inappropriate share price estimates, we will review two common issues in detail.

Using History as a Guide: In cases where a leveraged ESOP has been established, the levered corporate structure can have a profound influence on share price trajectory while the leverage remains in place. Very similar to the impact of a mortgage on the equity value of a home, even a modest



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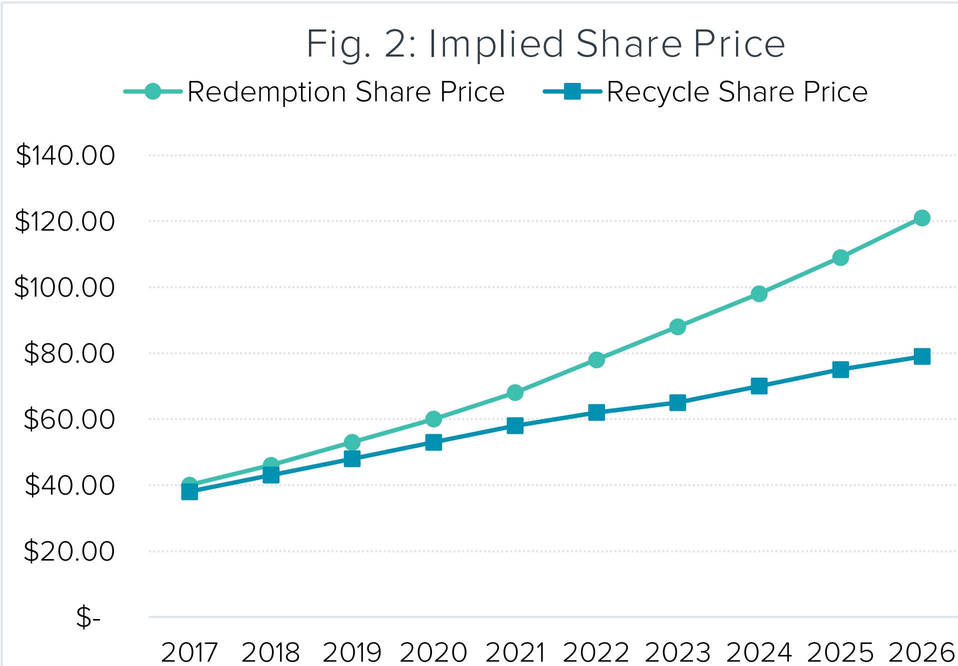
increase in the enterprise value of a company leads to a much larger increase in the value of the equity and the resulting per share price. For example, if a $10.0MM value company with $5.0MM of debt ($5.0 MM in equity value) grows by 10%, the resulting increase in equity and per share value would be 20% ($11.0MM less $5.0MM debt or $6MM in equity value). This effect can be seen in Figure 1. Note the more rapid equity growth during the early years when transaction debt is being repaid versus the lower equity growth once the repayment period ends. In this example, the utilization of recent share price growth in a repurchase obligation study, say 20% appreciation exhibited over the short run, will likely overstate the company's long-term share price trajectory, which would lead to an overestimation of future repurchase obligation (particularly in the later years).

Recycle vs. Redemption: The decision whether to recycle or redeem shares from departing participants can have a substantial impact on share price trajectory. To illustrate this point, Figure 2 displays the estimated share price trajectory of a 100% S Corporation ESOP under a pure recycle scenario as well as a pure redemption scenario.

Figure 2 illustrates the dramatic difference in the potential outcomes of these policy decisions. In most companies where a decision has been made to recycle all ESOP shares, and benefit levels are not actively managed, the share price trajectory is less than the pure redemption scenario. When companies choose to fully recycle ESOP shares, there is no reduction in the shares outstanding to offset the loss of company capital needed to



satisfy the repurchase obligation. Additionally, it is not uncommon for a pure recycle policy to cause an increase in employee benefit levels over time, which can also reduce future share price expectations.

Other Factors to Consider

ESOP policies are often established at the inception of the ESOP, with the effects of these decisions not usually felt until the ESOP ownership structure begins to mature. Proactive modeling of these decisions, along with company-specific factors, can help ESOP Trustees and management have a much deeper understanding of the cash flow, employee benefit and valuation impacts of such decisions well in advance of maturity. In cases where the balance of these factors is not in line with management's desires, modifications to current policies may be appropriate in order to better align policies with long term intent.

Additionally, as a best practice, it may also be prudent to conduct a series of repurchase obligation studies under various scenarios to ensure that the ESOP Trustee and management understand the impact of repurchase obligation during periods where significant workforce and valuation reductions/expansions occur.

Conclusion

In order for the ESOP Trustee and management to accurately quantify the impact of repurchase obligation, it is important to integrate multiple disciplines. When evaluating a company's repurchase obligation, it is equally important to conduct a thorough review of actuarial assumptions as well as the share price trajectory that is included within the analysis. Over/underestimating the share price trajectory can significantly reduce the benefits of conducting the analysis and may lead to poor operating decisions, as future claims on company cash may be more/less than anticipated. It is prudent to have the ESOP appraiser review and/or assist in the development of the per share estimates used in the repurchase obligation study to ensure that the study appropriately reflects the valuation methodologies utilized by the appraiser as well as company-specific policies.

About Prairie Capital Advisors

Prairie Capital Advisors offers investment banking, ESOP advisory, valuation advisory and financial reporting valuations to support the growth and ownership transition strategies of middle-market companies. Headquartered in Oakbrook Terrace, Illinois, the company is a leading advisor to closely-held companies nationwide. For more information, call 630.413.5574 or visit www.prairiecap.com.

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